

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Finding Value through Out of Favor, Overlooked, or Misunderstood Securities

JAMES C. ROUMELL is President and Lead Portfolio Manager at Roumell Asset Management, LLC. He entered the securities industry in 1986. Before founding the firm in 1998, he was a Registered Principal at Raymond James Financial Services, Inc. Mr. Roumell was selected to participate in, and won, two consecutive *Wall Street Journal* stock picking contests, in 2001 and 2002, before the contest was discontinued. Mr. Roumell has been featured in such publications as *Barron's*, *Kiplinger's*, *Value Investor Insight*, *Financial Planning Magazine* and *The Washington Post*. He is a graduate of Wayne State University in Detroit, Michigan. Mr. Roumell is also a Board Member of Transitional Housing Corporation, Inc., a not-for-profit group providing affordable housing to low-income residents of Washington, D.C.

SECTOR — GENERAL INVESTING

TWST: Please provide a little bit of history of Roumell Asset Management.

Mr. Roumell: I started the business in 1986 as a retail broker in Arlington, Virginia, and opened up one of the first Raymond James offices in the D.C. area in 1992. In the early 1990s, I became deeply enamored with securities analysis and particularly with deep value, and read the material of Marty Whitman, Third Avenue Value, and that became my guiding philosophy. I was fortunate enough to develop a relationship with Marty and began writing some research in the early to mid-1990s, some of which Marty acted upon in the Third Avenue Value fund in a brokerage relationship.

Then in 1998 I decided to form Roumell Asset Management, and we started out with maybe \$15 million at that time that were brokerage assets that became managed assets. We have built from there. We have basically done the same thing for 15 years now, which is to focus on out-of-favor, overlooked and misunderstood securities, principally with strong balance sheets. We use a lot of detective work in our research. Unlike some of our value peers, we do travel, we see customers, people in the company's ecosystem, suppliers.

In the past couple of months, we have been at the refrigeration manufacturers convention in Orlando, solely to talk to customers of our top holding, **Tecumseh Products** (TECUA). Ted has visited a natural gas field in Utah, that's a principal asset of one of our holdings, **Sandstorm Metals & Energy** (SND.V). Within the past couple of months, we have been at a large aftermarket distributor of compressors where **Tecumseh** sells a lot of its compressors to really get a sense of whether the mix on

the front end is changing in terms of who is gaining share. In general, I think it's very, very difficult to add value by looking at securities that are highly followed, if not popular.

We begin with a view that in order for us to add value, we have to typically be in a room where there is either not a lot of people, so we are more likely to gain an information edge and an analytic edge; or to the extent we do get in a liquid security, like we have with **Apple** (AAPL) recently, it is because we feel we can take advantage of a behavioral edge, which I would describe as basically willingness to be greedy when others are really fearful. In that case, we think when there is such mass movement, and such short-term mentality that builds on itself, and we are willing to exploit that — even recognizing in a situation like **Apple** that we have no information edge and we have no analytical edge, but I think we do have a temperamental edge.

In 15 years, basically 70% of our equity purchases have been micro and small cap, but 30% have been made in large cap that on occasion deeply get sold off. We bought **Merck** (MRK) in the aftermath of Vioxx, we bought **Berkshire Hathaway** (BRK-A) in the aftermath of Katrina. We made money on **Dell** (DELL) recently. The last shares of **Dell** we bought at \$9. We will buy some beaten-up securities if we feel they're suffering from a tremendous amount of investor disdain, while possessing strong balance sheets and identifiable problems that we believe are being overly discounted.

Now, we are not always right there. We also bought **Transocean** (RIG) in the aftermath of the Macondo event a couple of years ago. The rig company in **Transocean** had fallen from \$95, we got it at kind of \$65, and it fell down into the \$40s, and we exited at about \$55. We never

changed our view that the liability of **Transocean** was going to be very digestible. That was the initial analysis and that was correct. What we got concerned about as the Macondo well continued to spill oil in the Gulf, was that it could really reduce demand for ultradeepwater drilling, and that that would really change day rates and the economics of the business. We are cap-structure agnostics. So on the same day we actually sold our **Transocean** stock, we bought **Transocean** debt at \$0.90 that matured two years later at par. So we will look throughout the capital structure, we are very opportunistic. We have a broad mandate. In the fourth quarter of 2008, we had less than 5% of our assets in fixed income. And by the end of 2009 it was 40% all high yield, bought at \$0.40, \$0.50, \$0.60 when credit spreads widened out 20% over.

TWST: You have described your approach as “a different approach to deep-value investing.” Would you explain that a little more?

Mr. Roumell: Over the years, we have struggled with trying to create a very easy to understand description of what we do, and for a couple of years we used “a different approach to deep value.” When we put that tag line together, we had a couple of things in mind. Number one, we don’t mind buying a growth stock. Whereas traditional value investors are often associated with focusing on **Sears Roebuck** (SHLD) or **J.C. Penney** (JCP) turnaround stories, which have real estate and so forth, we are interested in growth as well. We just don’t want to pay for it. We want to try to get it for free, and we try to get it free in different ways.

would use the analogy of when you walk into **Bloomingdale’s**, about 80% of the goods there are going to be overvalued and can probably be purchased cheaper elsewhere. But sometimes you find a unique situation. A couple of years ago, I found a suit that had 40% knocked off and there was a little cut on the back of the knee and they knocked off another 25%, so I got over 50% off a great suit. It does happen, you can find good values, but we would say this market is expensive to us.

Although the market does have forward earnings of 14 times or 15 times, it’s still much more expensive on a 10-year-adjusted p/e basis, kind of the Shiller CAPE.

We think earnings should be looked at over 10 years, not one year. Current earnings coming off the S&P are coming off the highest operating margins post war. If you look at a chart where corporate profit margins are right now, they are at about 13%, when the post-war median has been about 9.5%. And if margins revert to the mean, you no longer have the S&P earning \$110. There is a lot of faith put on the fact that the market is at a modest p/e, but it’s really being driven by an abnormally high — the highest, in fact — post-war operating margin, which we don’t think is sustainable. If you look at nonearnings measures like market cap to GDP or price to sales of the economy, the market is over 100% of GDP right now, and the post-war median has been more like 65%.

At the end of the day, we find a security we like, we’re going to buy it because we’re looking at it as if we were taking it private. If you’re going to take something private and you are going

Highlights

James Roumell discusses his firm’s investment strategies, which encompasses out-of-favor, overlooked and misunderstood securities, with strong balance sheets. He says most equity purchases in Roumell’s history have been micro- and small-cap companies and he provides specific examples of successful holdings and exits in the portfolio. Mr. Roumell also explains the idea of the “pervasiveness of the short term.”

Companies include: Tecumseh Products (TECUA); Sandstorm Metals & Energy (SND.V); Apple (AAPL); Merck & Co. (MRK); Berkshire Hathaway (BRK-A); Dell (DELL); Transocean Ltd. (RIG); Sears Holdings (SHLD); J.C. Penney Company (JCP) and Ultra Petroleum (UPL).

“[M]ost traditional value is really associated with a deep commitment to buy and hold, and we don’t mind selling under the right circumstances. So I don’t think we have the same commitment to buy and hold that a lot of traditional deep value has, and we’re highly opportunistic.”

Another way in which we are different is most traditional value is really associated with a deep commitment to buy and hold, and we don’t mind selling under the right circumstances. So I don’t think we have the same commitment to buy and hold that a lot of traditional deep value has, and we’re highly opportunistic. Right now in our fund, we are holding 35% cash. The tag line we have focused on now is on finding value through out-of-favor, overlooked or misunderstood securities. That is probably a more accurate description of what we do.

TWST: You said you are holding 35% cash right now. What determines how much cash you hold?

Mr. Roumell: We will hold cash if we don’t have a great idea where we want to invest. If we have an idea that grabs us, we will absolutely buy it. There is no hesitation to deploy capital if we can justify it on a company-specific basis. We are not trying to predict market movements in general. Sometimes there is not great pricing available. It’s not to say that things don’t become available here and there. I

to own it, you are really not worrying about things like what the Chinese growth rate is going to come in at. I use the analogy if I was looking at a dry cleaner down the street and they were generating a hundred thousand dollars in cash flow a year and there was an apartment building going up down the street, so I knew there were more people coming into the neighborhood and I could buy that at 6.5 times earnings; and then they also own the real estate, so that if the dry cleaner business didn’t make it I’d still have a piece of real estate. If I could get that kind of pricing, I couldn’t care a less what Chinese GDP is going to do.

TWST: Is J.C. Penney one of your holdings?

Mr. Roumell: We own the **J.C. Penney** debt. We bought the debt, and we paid about \$83 for it. And the analysis was really based on, A, we didn’t want to speculate in the equity, but we felt that they owned 40% of the real estate, which made it attractive. We just sold the **J.C. Penney** debt out at \$87. The reason we did that was because of the

Goldman Sachs loan of \$1.75 billion that is basically secured by the real estate. And so even though our bonds were senior unsecured just like the rest of the paper, what effectively happened is we got debt put on top of us that was secured. On the one hand, equity investors like it because it gives a lot more liquidity and a lot more breathing room, and chance to actually turn it around. Interestingly, the equity is probably a better risk/reward than the debt now. But from our standpoint, we weren't really speculating on a turnaround as much as modeling through that in the event of a filing, we would be protected. Without that protection now, with a senior secured piece of paper ahead of us, it's no longer the same investment rationale.

1-Year Daily Chart of Tecumseh Products



Chart provided by www.BigCharts.com

“We think Ultra has great assets. They are long-life assets. They have an average life of about 17 years. We’re bullish long-term on natural gas, but more importantly, with Ultra you don’t have to be that bullish on natural gas. Because they are such a low-cost producer, they don’t need dramatically high prices to succeed.”

TWST: What about Ultra Petroleum? Why do you own that company?

Mr. Roumell: We think Ultra (UPL) has great assets. They are long-life assets. They have an average life of about 17 years. We’re bullish long-term on natural gas, but more importantly, with Ultra you don’t have to be that bullish on natural gas. Because they are such a low-cost producer, they don’t need dramatically high prices to succeed. The industry median all-in lifting cost is \$6.31 per Mcfe, and Ultra’s is at \$3.00. They anticipate that if gas prices go from \$3.50 to \$4.50 per Mcf, they can double Ultra’s EBITDA from \$600 million to \$1.2 billion. There is a lot of leverage in the model, it’s a very well run business. Michael, the CEO, has \$75 million worth of stock. We just met with them a couple of months ago. We see more and more utilities as is described in the first-quarter letter converting to natural gas. We think eventually, you’ll have LNG where they will be exporting of natural gas.

Also, short of LNG, they really think they will be shipping down to Mexico, which doesn’t require all the building, the LNG facilities that are needed to ship natural gas abroad. They think there is a big opportunity by going south of the border. It fits the out-of-favor paradigm perfectly. It is also well capitalized. A few years ago, Ultra touched \$100 a share. Our average cost is \$18.5, and the number of bullish analysts on the stock was 25% when we bought our first share. The number of bullish analysts was 80% when the stock was trading close to \$100.

TWST: You sell when you meet your price targets. Are there other reasons you would sell something out of a portfolio?

Mr. Roumell: J.C. Penney is a good example. If we get new material information, we may sell. With J.C. Penney, we did not like being subordinated. Now there is senior secured paper ahead of us, which is fine if the bond remains performing, which is likely, but it’s not fine if the company actually files. The investment thesis was that we were supported by a lot of real estate that was not secured; well it is now. So that wasn’t really so much a price target change, it was a new material piece of information that we felt changed the risk/reward dynamic of the security.

TWST: In your first-quarter newsletter, you talked about the pervasiveness of the short-term. What you mean?

Mr. Roumell: Let’s take Ultra as an example. Investors loved Ultra at \$90 and \$100 when natural gas price was above \$13/Mcfe, because the short-term outlook for natural gas was so positive, and they loved it. They are really focused on the information right in front of their noses. Similarly now, although natural gas prices having significantly moved up from a bottom, the immediate near-term outlook is still very uncertain, and that’s what they are focused on. They are watching the price of natural gas in the next quarter, around the next couple of years, and not recognizing that at the end of the day, it really isn’t so much about what natural gas prices are in the next quarter, it’s what price are you paying. Given the risks of the security, it’s always price versus value.

I put the short-termism in two camps, and we used examples of each in our first-quarter letter. One camp are the “strategists.” So in

1-Year Daily Chart of Ultra Petroleum



Chart provided by www.BigCharts.com

2009, things are burning around you, municipalities are going to just start going bankrupt and so the short-termism was to be just totally absorbed in the headlines of the day. The headlines of the day were municipalities are struggling to meet their budgets and stimulus money coming from the Federal Government was going to dry up, and so municipalities are going to default and the cascading effects of that are going to be catastrophic, so stay away from the market. Well, markets now have gone up

over 100%, and those who were negative are now saying they've never been more bullish. I think it's very short term to anticipate that current corporate operating profit margins are going to stay up where they are. So that's from the strategists' point of view. And then I would say the same of analysts or investors on an individual security basis who are more focused on today's price of natural gas rather than tomorrow's.

TWST: In your opinion, what does your firm do particularly well?

Mr. Roumell: We all end up doing what we think we're good at, right? You leverage what skills you believe you have. Someone who isn't maybe particularly comfortable with reaching out and developing relationships is more focused on forensic accounting, because they can sit in a room looking at spreadsheets and numbers all day. For me, I think we're very good at analyzing the information we get from a company and conducting an interview in a way that helps to really develop a narrative. The FBI has made a science of questioning, and one of the easiest things you do obviously is you ask a few questions that you know the answer to and see if they are answered accurately. Through that process, you begin to find out if you are sitting across from someone you can trust.

I think things are going to go wrong in business and things are going to happen unexpectedly, but knowing who the captain of the ship is can keep you out of a lot of trouble if you have confidence that they are skilled operators acting with integrity. I think that a lot of money is lost by bad management, either from a competence standpoint or from an

integrity standpoint. One thing we've learned over the past few years is there are some management teams out there that are so entrenched, and it is very, very clear that their chief goal is to keep employment contracts, and that is what is motivating them. Their motivation is not to maximize shareholder value, it's to do an acquisition to create a complication, to create two years of integration work that secures them a job. You need to know that because you are basically deciding, do you want to partner with these people? So clearly there are other investment approaches that are looking for these types of management teams that they can buy shares and then take them on, and that's obviously a different investment narrative. We have done a little bit of that, but it's always been kind of out of necessity, not by design.

TWST: Thank you. (LMR)

JAMES C. ROUMELL
President & Lead Portfolio Manager
Roumell Asset Management, LLC
2 Wisconsin Circle
Suite 660
Chevy Chase, MD 20815
(301) 656-8500
(301) 656-8501 — FAX
www.roumellasset.com

Disclosure: The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for advisory clients, and the reader should not assume that investments in the securities identified and discussed were or will be profitable.